No. 9824

In the United States Circuit Court of Appeals for the Ninth Circuit

Artesian Water Company, a Corporation, petitioner

v.

Commissioner of Internal Revenue, respondent

ON PETITION FOR REVIEW OF THE DECISION OF THE UNITED STATES BOARD OF TAX APPEALS

BRIEF FOR THE RESPONDENT

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OPINION BELOW

The opinion of the United States Board of Tax Appeals (R. 21–37) is reported at 43 B. T. A. 408.

JURISDICTION

This case involves deficiencies in income taxes in the calendar year 1937 in the amount of $7,380.33. (R. 38.) The order of the Board was entered January 24, 1941 (R. 37–38), and the taxpayer filed a petition for review on April 16, 1941 (R. 38–41), in accordance with the provisions of Sections 1141 and 1142 of the Internal Revenue Code.

QUESTIONS PRESENTED

The questions presented to this Court are:

1. Whether the taxpayer is entitled to an exemption from the undistributed profits tax by virtue of Section 14 (d) (2) of the Revenue Act of 1936; or

2. If not falling within the exemption, whether the taxpayer is entitled to a credit under either Section 26 (c) (1) or Section 26 (c) (2).

STATUTE AND REGULATIONS INVOLVED

The statute and regulations involved are set forth in the Appendix, *infra*, pp. 14–18.

STATEMENT

On November 12, 1929, the taxpayer, a California corporation (R. 23), refinanced a loan owing to the Pacific Mutual Life Insurance Company, executing a 6 percent promissory note for $175,000 due November 12, 1934. Subsequently another similar note was executed for $35,000. (R. 24, 54–55, 59–60.) Both notes were secured by a mortgage on unimproved farm lands (R. 24, 58), the mortgage providing that it should secure any subsequent loans (R. 68). The original note was further secured by an assignment of a lease of certain oil properties which the Shell Oil Company leased from the taxpayer. However, all royalties from the lease were paid by Shell Oil directly to the taxpayer. A separate agreement was made concerning the $35,000 note to the effect the taxpayer would refrain from declaring any dividends while the note was unpaid. (R. 24–25.) The mortgage covered substantially the major portion of the company's assets, while the lease to

Shell Oil yielded over 90 per cent of the income. (R. 23, 24, 77.)

In July, 1935, the taxpayer was placed in receivership under the California law. The receiver was appointed as a result of a petition filed by a judgment creditor of one of taxpayer's stockholders. The judgment creditor, having acquired stock of the taxpayer at a sheriff's sale, applied to the corporate officers of the taxpayer to transfer the stock to him on the company's books. Upon the refusal of the officers to do so, the judgment creditor petitioned for the appointment of a receiver on the ground that the company's officers were not functioning under California law. The receivership had no connection with taxpayer's ability or disability to pay its debts, nor did the Pacific Mutual have anything to do with it. The taxpayer owed no debts other than current obligations which were paid when due. (R. 25–27.)

Sometime around the middle of the year 1936 a conservator was appointed for the Pacific Mutual and the loans to the taxpayer came under close scrutiny and severe criticism, because of certain interlocking interests between the two companies. (R. 46, 78.)

Nothing was paid on the principal of this obligation until late in 1936. In September of that year an agreement was reached between the receiver and the conservator whereby the time for payment of the loan was extended to March 2, 1937, conditioned upon certain payments being made during the ensuing period. This agreement was evidenced by an exchange of letters. (R. 27, 83.) During 1936 the receiver paid $25,000 on

the notes and made additional payments during 1937, reducing the total balance due to $100,250. The smaller note was paid off in full during 1937 and the larger one in 1938. (R. 61, 55.)

The taxpayer had net income of $54,101 during 1937 on which it paid the normal tax. (R. 33, 113.) This case involves the deficiency asserted by the Commissioner of Internal Revenue in the surtax for the year 1937.

The Commissioner, in his deficiency notice, stated that the taxpayer was not, under the facts presented, entitled to an exemption. A credit of $8,250 representing the amount paid during 1937 on the $35,000 note was allowed as a credit for contracts restricting dividends.[1] The amounts paid on the $175,000 note were not allowed. The Board upheld the Commissioner. (R. 22–23.)

SUMMARY OF ARGUMENT

The Board's finding that the taxpayer was not insolvent is supported by substantial evidence and therefore is conclusive on this Court. Hence, it is not entitled to the exemption from the surtax provided in Section 14 (d) (2). The execution of promissory notes, secured by a mortgage on most of taxpayer's assets and by the assignment of a lease constituting the principal source of taxpayer's income, does not constitute a written contract expressly dealing with the payment of dividends nor a written contract expressly dealing with the disposition of earnings and profits, within the meaning of

[1] There is no reference in this record to the contract upon which this credit was based. However, the amount of the credit granted is not in issue.

Section 26 (c) (1) and 26 (c) (2). Hence the corporation is not entitled to a credit under either of those provisions.

ARGUMENT

I

The taxpayer was not entitled to an exemption under section 14 (d) (2)

Section 14 of the Revenue Act of 1936 imposed a surtax on corporate profits, earned but not distributed during the tax year. Section 14 (d) (2) provided an exemption for corporations in bankruptcy or insolvent and in receivership. Section 26 (c) (1) granted a credit for undistributed profits that could not be distributed during the taxable year as dividends "without violating a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the payment of dividends." Similarly, Section 26 (c) (2) granted a credit for undistributed earnings and profits which were required to be paid or irrevocably set aside within the taxable year for the discharge of a debt by "a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the disposition of earnings and profits for the taxable year."

The first question to be resolved is whether this taxpayer was entitled to an exemption under Section 14 (d) (2). We may concede, for the purposes of this part of the argument, that it is enough if the corporation is insolvent and in receivership and the nature of the receivership proceeding is immaterial. However,

the Commissioner and the Board must determine whether the taxpayer was insolvent. Such a determination is essentially a finding of fact which, if supported by substantial evidence, is conclusive. *Elmhurst Cemetery Co.* v. *Commissioner,* 300 U. S. 37, reversing 83 F. (2d) 4 (C. C. A. 7th); *Oak Woods Cemetery Ass'n.* v. *Commissioner,* 111 F. (2d) 863 (C. C. A. 7th), certiorari denied, 308 U. S. 616. Of course, if there is no evidence to support the Board's finding, this Court would be entitled to reverse. Cf. *United States* v. *Anderson Co.,* 119 F. (2d) 343 (C. C. A. 7th); *Commerce Trust Co.* v. *Woodbury,* 77 F. (2d) 478 (C. C. A. 8th), certiorari denied, 296 U. S. 614; *Central West Public Service Co.* v. *Craig,* 70 F. (2d) 427 (C. C. A. 8th). However, the taxpayer has the burden of presenting substantial evidence to offset the Commissioner's determination. See *Fesler* v. *Commissioner,* 38 F. (2d) 155 (C. C. A. 7th), certiorari denied, 281 U. S. 755; *Brown* v. *Commissioner,* 22 F. (2d) 797 (C. C. A. 5th.)

It cannot seriously be contended that the taxpayer was insolvent in a bankruptcy sense of having liabilities exceeding assets. The balance sheet, as filed with the company's income tax return for the year, showed total assets of $1,162,798, and total liabilities, exclusive of capital stock and surplus, listed at $144,255. Substantially, the same situation had existed at the beginning of the year. (R. 33, 113.) In the taxpayer's brief (p. 16) there is an attempt to discredit the Board's finding on the ground that the figures given above were merely book values as of March, 1913, claiming that the values were less in 1937, and that no depletion for

oil had been charged against assets on the books. The only testimony regarding the value of the assets was that the receiver, admittedly not a real estate man, who "wouldn't know" but "would say" that there would be a substantial difference in such values. (R. 100.) The testimony regarding depletion was to the effect that if the undivided profits at the end of the year of $34,442 had been reduced by the claimed depletion of $44,863, there would be no undivided profits balance but a deficit of approximately $10,400. Admitting the mathematical accuracy of this calculation, it is submitted that it has no effect on the present issue. A deduction from undivided profits would not affect the balance between assets and liabilities, exclusive of capital stock and surplus. Clearly, there is no evidence here which the Board would have been justified in using to offset the balance sheet figures. Nor is there any evidence in the record to warrant a finding that the assets were overvalued on the company's books by something over a million dollars which would be the adjustment necessary to make liabilities exceed assets.

Therefore, the principal question under the exemption section is whether the taxpayer was insolvent in the so-called equity sense—that is, was it unable to meet its currently maturing obligations. The problem was well posed in *United States* v. *Anderson Co., supra,* where the court said (p. 345):

> The practical question is—Under what circumstances may a court say that a corporation is unable to pay its debts as they fall due in the usual course of trade or business?

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It will be noted that in defining insolvency the authorities stress the fact that it means inability to pay debts as they become due in the ordinary course of business. See *Dutcher* v. *Wright,* 94 U. S. 553; and *Cincinnati Equipment Co.* v. *Degnan,* 184 Fed. 834 (C. C. A. 6th). The record in this case shows that all debts of this company were paid except the obligation owed to the Pacific Mutual (R. 97), which debt originally fell due in November, 1934. The record is somewhat indefinite with regard to what steps, if any, were taken to secure an extension or to refinance the debt from the due date until 1936. It may be that originally a request for an extension was refused (R. 84) but insofar as there is any substantial evidence in this record it is evident that the negotiations were not seriously undertaken until 1936, although the receiver had been appointed in July, 1935. (R. 77.) At no time did the taxpayer become involved in any legal proceedings because of its inability to pay its bills. (R. 97.) Nothing was paid on the principal of this obligation from the time the loan was made until late in the year 1936. (R. 85.) It was around the middle of 1936 that a conservator had been appointed for the insurance company (R. 46, 78) and it would appear that it was only after that time that the creditor began to be really concerned about the liquidation of the loan (R. 78). There is certainly substantial evidence to support a finding that this obligation was not "currently maturing." Since the debt had originally become due in 1934 and the creditor took no steps for its collection other than to grant an extension in September, 1936, until March, 1937, it is quite

apparent that the creditor was acquiescent in the installment payment of this debt. Moreover, after March, 1937, the creditor continued to permit the debtor to pay off the debt in installments. From these facts it would be impossible to consider that this obligation was one falling due in the ordinary course of business. In effect and in reality, the creditor was placing reliance upon the debtor's ultimate ability to pay and was not demanding immediate payment. This clearly amounts to an extension of credit. When able to meet its obligations by reasonable use of credit a debtor is not insolvent. *United States* v. *Anderson Co., supra; Coffman* v. *Publishing Co.,* 167 Md. 275, 173 Atl. 248; *Long* v. *Republic Varnish Enamel &c., Co.,* 115 N. J. Eq. 212, 169 Atl. 860. Since the taxpayer was neither insolvent, in the sense of an excess of liabiilties over assets, nor insolvent, in the sense that it could not meet its current obligations, it was not within the terms of the exemption.

As an alternative and additional argument, it is submitted that the taxpayer did not come within the exemption since the receivership intended by this section was obviously intended to mean one caused by financial difficulties and not one arising from disputes between the stockholders, charges of mismanagement, failure to obey the laws, etc. As shown by the Committee Reports on this bill, the intent of Congress was to exempt those corporations in a weak financial condition.[2] In

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[2] Adequate safeguards are provided in the bill to prevent unreasonable taxation of incomes in the case of corporations in distress or with inadequate earnings to take care of their immediate needs. * * * H. Rep. No. 2475, 74th Cong., 2d Sess.,

the instant case the receivership had no connection with the financial condition of the taxpayer; it arose out of a suit against a stockholder by his judgment creditor and the subsequent officers of the company. (R. 25.) In order for a company to use this exemption, it must be in receivership as well as insolvent. *Cooperative Pub. Co.* v. *Commissioner,* 115 F. (2d) 1017 (C. C. A. 9th).

II

The taxpayer was not entitled to either of the credits granted in Section 26 (c) (1) or 26 (c) (2)

The theory of the taxpayer's case is that by giving the mortgage note for $175,000 and assigning the lease to the creditor it became entitled to the credit allowed under Section 26 (c) (1) or (2). It is well settled that a credit provision in the tax law should be as strictly construed as an exempting provision. *Helvering* v. *Northwest Steel Mills,* 311 U. S. 46; *Helvering* v. *Inter-Mountain Insurance Co.,* 294 U. S. 686; *Crane-Johnson Co.* v. *Commissioner,* 105 F. (2d) 740 (C. C. A. 8th), affirmed, 311 U. S. 54. The *Northwest Steel Mills* case is directly contrary to the taxpayer's contention that Section 26 (c) is to be liberally construed. There the Court stated (p. 49):

> * * * Congress indicated that any exempted prohibition against dividend payments must be expressly written in the executed contract. * * * the granted credit can only

p. 4 (1939–1 Cum. Bull. (Part 2) 667, 669). To the same effect is S. Rep. No. 2156, 74th Cong., 2d Sess., p. 14 (1939–1 Cum. Bull. (Part 2), 678).

> result from a provision which "expressly deals with the payment of dividends."

There was nothing in the mortgage, nor insofar as the record reveals in the assignment, that "expressly deals with the payment of dividends." Hence, Section 26 (c) (1) clearly does not apply.

It matters not what was the effect of the state law concerning the mortgage and assignment, since it is well settled that statutes specifically prohibiting dividend payments do not constitute written contract executed by the corporation prohibiting such payments within the meaning of Section 26 (c) (1). *Helvering* v. *Northwest Steel Mills, supra; Utah Hotel Co.* v. *Hinckley,* 115 F. (2d) 920 (C. C. A. 10th); *Bastian Bros. Co.* v. *McGowan,* 113 F. (2d) 489 (C. C. A. 2d), certiorari denied, 311 U. S. 702; and *Cooperative Pub. Co.* v. *Commissioner, supra.* The whole theory of these authorities is that although the corporation might not be able to declare dividends because of the effect of some superior force upon it, the credit was not allowable except when there was a written contract executed by the corporation dealing expressly and not impliedly with the question.

Similar principles apply in determining whether a credit is allowable under Section 26 (c) (2). In order to be entitled to a credit under that section the corporation must have executed prior to May 1, 1936, a written contract containing a specific provision requiring a portion of its earnings and profits of the taxable year to be paid or set aside in discharge of a debt. There is no such contract here.

Any promise to make periodic payments on an indebtedness would naturally be restrictive as to the earnings and profits of the debtor but it can hardly be contended that Congress meant to include within this section all promises to liquidate just debts. It was intended that the exemption apply only when an explicit contract required it to apply specifically a portion of its earnings for the current year to the payment of a debt. Here the royalties from the lease were paid directly to the taxpayer and the taxpayer concedes that it was properly required to report the royalties as its income. (Br. 20.) Although the creditor might, by virtue of the state law, be entitled to demand them from the taxpayer, it is the force of the state law which gives him this right and not an express contract dealing with the disposition of the earnings and profits. See *Helvering* v. *Northwest Steel Mills, supra.* The income from the lease was assigned as security for the loan. (R. 24.) If the taxpayer chose to pay the creditor from other sources he would not care from what source he were paid. Clearly this assignment as security was not an express contract requiring the debtor to pay or irrevocably set aside a portion of the earnings during the taxable year.

If the taxpayer's theory were applied literally, it would follow that all payments on account of legally owing debts would constitute a credit against this tax, since any payment on a debt will have a restrictive effect on the company's profits. It is a rare corporation that is not making payments on borrowed capital. But Congress has not provided relief in such cases. It

has stated with meticulous care the circumstances under which a credit would be allowed. The allowance of credits and deductions is within the discretion of Congress and the language of the statute cannot be stretched to cover this case because of any alleged hardship on the taxpayer. See *Helvering* v. *Northwest Steel Mills, supra.*

Moreover, the hardship here is more imaginary than real. This corporation was a profitable going concern during the year in question and should not escape this tax merely because during those years it repaid a large amount of its indebtedness. If there could be any unfairness in the instant case, it would be the unfairness to other corporations which paid this tax while making a profit although not in a sound enough financial condition to repay their capital investments.

CONCLUSION

The decision of the Board that the taxpayer was not exempt and was not entitled to a credit for the amounts paid was correct and should be affirmed.

Respectfully submitted.

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August, 1941.

APPENDIX

Revenue Act of 1936, c. 690, 49 Stat. 1648:

SEC. 14. SURTAX ON UNDISTRIBUTED PROFITS.

* * * * *

(b) *Imposition of Tax.*—There shall be levied, collected, and paid for each taxable year upon the net income of every corporation a surtax equal to the sum of the following, subject to the application of the specific credit as provided in subsection (c):

7 per centum of the portion of the undistributed net income which is not in excess of 10 per centum of the adjusted net income.

* * * * *

(d) *Exemption From Surtax.*—The following corporations shall not be subject to the surtax imposed by this section:

* * * * *

(2) Domestic corporations which for any portion of the taxable year are in bankruptcy under the laws of the United States, or are insolvent and in receivership in any court of the United States or of any State, Territory, or the District of Columbia.

* * * * *

SEC. 26. CREDITS OF CORPORATIONS.

In the case of a corporation the following credits shall be allowed to the extent provided in the various sections imposing tax—

* * * * *

(c) *Contracts Restricting Payment of Dividends.*—

(1) PROHIBITION ON PAYMENT OF DIVIDENDS.—An amount equal to the excess of the adjusted net income over the aggregate of the amounts

which can be distributed within the taxable year as dividends without violating a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the payment of dividends. If a corporation would be entitled to a credit under this paragraph because of a contract provision and also to one or more credits because of other contract provisions, only the largest of such credits shall be allowed, and for such purpose if two or more credits are equal in amount only one shall be taken into account.

(2) Disposition of Profits of Taxable Year.—An amount equal to the portion of the earnings and profits of the taxable year which is required (by a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the disposition of earnings and profits of the taxable year) to be paid within the taxable year in discharge of a debt, or to be irrevocably set aside within the taxable year for the discharge of a debt; to the extent that such amount has been so paid or set aside. For the purposes of this paragraph, a requirement to pay or set aside an amount equal to a percentage of earnings and profits shall be considered a requirement to pay or set aside such percentage of earnings and profits. As used in this paragraph, the word "debt" does not include a debt incurred after April 30, 1936.

* * * * *

Treasury Regulations 94, promulgated under the Revenue Act of 1936:

Art. 14–1. *Surtax on undistributed profits of corporations.*—

* * * * *

A domestic corporation is not subject to the surtax on undistributed profits if for any portion of its taxable year—

(1) it is in bankruptcy under the laws of the United States; or

(2) it is insolvent and in receivership in any court of the United States or any State, Territory, or the District of Columbia.

* * * * *

ART. 26–2. *Credit in connection with contracts restricting payment of dividends.*—(a) The credit provided in section 26 (c) with respect to contracts restricting the payment of dividends is not available under every contract which might operate to restrict the payment of dividends, but only with respect to those provisions of written contracts executed by the corporation prior to May 1, 1936, which satisfy the conditions prescribed in the Act. The charter of a corporation does not constitute a written contract executed by the corporation within the meaning of section 26 (c). The provisions recognized by the Act are of two general types, as folows:

(1) Those which come within section 26 (c) (1), in that they prohibit or limit the payment of dividends during the taxable year; and

(2) Those which come within section 26 (c) (2), in that they require the payment, or irrevocable setting aside, within the taxable year, of a specified portion of the earnings or profits of the taxable year for the discharge of a debt incurred on or before April 30, 1936.

* * * * *

(b) *Prohibition on payment of dividends.*—The credit provided in section 26 (c) (1) is allowable only with respect to a written contract executed by the corporation prior to May 1, 1936, which expressly deals with the payment of dividends and operates as a legal restriction upon the corporation as to the amounts which it can distribute within the taxable year as dividends. If an amount can be distributed within the taxable year as a dividend—

(1) in one form (as, for example, in stock or bonds of the corporation) without violating the

provisions of a contract, but can not be distributed within the taxable year as a dividend in another form (as, for example, in cash) without violating such provisions, or

(2) at one time (as, for example, during the last half of the taxable year) without violating the provisions of a contract, but can not be distributed as a dividend at another time within the taxable year (as, for example, during the first half of the taxable year) without violating such provision—

then the amount is one which, under section 26 (c) (1), can be distributed within the taxable year as a dividend without violating such provisions.

The credit provided in section 26 (c) (1) is equal to the excess of the adjusted net income, as defined in section 14 (a), over the aggregate of the amounts which can be distributed within the taxable year without violating the provisions of such contract. The requirement that the provisions of the contract expressly deal with the payment of dividends is not met in case (1) a corporation is merely required to set aside periodically a sum to retire its bonds, or (2) the contract merely provides that while its bonds are outstanding the current assets shall not be reduced below a specified amount.

* * * * *

(c) *Disposition of profits of taxable year.*—Under the provisions of section 26 (c) (2), a corporation is allowed a credit in an amount equal to that portion of the earnings and profits of the taxable year which, by the terms of a written contract executed by the corporation prior to May 1, 1936, and expressly dealing with the disposition of the earnings and profits of the taxable year, it is required within the taxable year to pay in, or irrevocably to set aside for, the discharge of a debt incurred on or before April 30, 1936. The credit is limited to that amount

which is actually so paid or irrevocably set aside during the taxable year pursuant to the requirements of such a contract.

Only a contractual provision which expressly deals with the disposition of the earnings and profits of the taxable year shall be recognized as a basis for the credit provided in section 26 (c) (2). A corporation having outstanding bonds is not entitled to a credit under a provision merely requiring it, for example, (1) to retire annually a certain percentage or amount of such bonds, (2) to maintain a sinking fund sufficient to retire all or a certain percentage of such bonds by maturity, (3) to pay into a sinking fund for the retirement of such bonds a specified amount per thousand feet of timber cut or per ton of coal mined, or (4) to pay into a sinking fund for the retirement of such bonds an amount equal to a certain percentage of gross sales or gross income. Such provisions do not expressly deal with the disposition of earnings and profits of the taxable year. A contractual provision, however, shall not be considered as not expressly dealing with the disposition of earnings and profits of the taxable year merely because it deals with such earnings and profits in terms of "net income," "net earnings," or "net profits."

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